

**Analyst: Paul Sham**
**HANG SENG BANK LIMITED (恒生銀行)**

Sector	: Banking	Chairman	: Dr. Raymond K. F. Ch'ien
HKSE Code	: 00011		
Market Price	: HK\$155.40 (04/08/2008)	Vice-Chairman & Chief Executive	: Mr. Raymond C. F. Or
Shares Issued	: 1,911.843m		
Mkt. Cap.	: HK\$297,100.4m	Managing Director & Deputy Chief Executive	Mr. Joseph C. Y. Poon
52 weeks Hi/ Lo	: HK\$170.00 / HK\$104.10		
HSI	: 22,514.92 (04/08/2008)		
Main Business	: Banking and related financial services		

**SUMMARY OF THE INTERIM RESULTS FOR THE SIX MONTHS ENDED 30<sup>TH</sup> JUNE 2008**
**Interim Results Highlights**

	HK\$ million	Vs 1H2007 (%)	Vs 31/12/2007 (%)
• Net interest income	8,252	+23.2%	
• Non-interest income	4,368	+2.3%	
• Total operating income	12,620	+15.1%	
• Operating expenses	(3,320)	+13.9%	
• Operating profit before impairment losses	9,300	+15.5%	
• Impairment losses on loans and other credit risk provisions	(188)	-32.9%	
• Profit before taxation	10,530	+3.1%	
• Taxation	(1,466)	+27.5%	
• <b>Attributable profit to shareholders</b>	<b>9,064</b>	<b>+2.2%</b>	
• Total loans	338,202	+8.4%	+9.3%
• Total deposits	580,108	+3.9%	-1.8%
• Total assets	747,916	+0.9%	+0.3%
• Basic EPS (HK\$)	4.74	+2.2%	
• 1st & 2nd interim EPS (HK\$)	2.20	unchanged	
<b>Selected Ratios</b>	<b>1H2008</b>	<b>1H2007</b>	<b>FY2007</b>
• <b>Net interest margin</b>	<b>2.43%</b>	2.11%	2.23%
• Cost-income ratio	26.3%	26.6%	26.6%
• Return on average assets	2.4%	2.5%	2.6%
• <b>Return on average equity</b>	<b>32.8%</b>	36.6%	35.4%
• Impaired loan ratio	0.41%	0.46%	0.41%
• Impaired advances coverage	75.1%	68.4%	83.5%
• Loan-deposit ratio	58.3%	55.9%	52.4%
• Capital adequacy ratio (#)	13.9%	12.3%	11.2%
• Average liquidity ratio	47.3%	52.9%	52.9%

#The capital adequacy at 30 June 2008 was calculated in accordance with Basel II – foundation internal ratings-based approach which became effective on 1 January 2008, while those at or before 31 December 2007 were calculated in accordance with Basel II – standardised approach.

- **1H2008 results beat market expectations** Hang Seng Bank (HSB) reported a net profit of HK\$9,064m in the first half of 2008, up 2.2% y-o-y. This was higher than the consensus forecasts of HK\$8,946m. Major discrepancies came from better-than-expected net interest margin and a higher profit contribution from Industrial Bank. Excluding a one-off gain of HK\$1.46bn from its investment in Industrial Bank in 1H07, attributable profit would have been 22.5% higher. DPS was maintained at HK\$2.20 while dividend payout ratio was lowered to 43.7% in 1H08 (1H07: 52.9%).

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- **Significant improvement in NIM** The net interest margin rose to 2.43% compared to 2.11% in 1H07 and 2.33% in 2H07 despite the sharp fall in HIBOR. This was due mainly to the better treasury spreads, the widening credit spread on commercial loans on its shift towards higher-yield manufacturing loans and a rise in the loan-to-deposit ratio from 52.4% at the end of December 2007 to 58.3% at the end of June 2008.
- **Healthy loan growth** Customer advances rose 9.3% with encouraging growth in manufacturing loans (+65.6% h-o-h), property-investment lending (+10.4% h-o-h) and residential mortgages (+8.0% h-o-h). Loan outside HK also recorded strong growth of 17.3% h-o-h, supported by the solid growth of China loans (+14.7% h-o-h).
- **Net fees increased moderately by 5.8% y-o-y and declined by 24.8% h-o-h** Fee income was the key disappointment of the 1H08 result, which delivered only 5.8% growth y-o-y. Private banking investment services fee income was adversely affected, declining by 46.8% y-o-y or 73.5% h-o-h, due largely to a lower transaction volume in the less favourable investment environment. The fees from the securities brokerage, retail investment funds and structured investment products businesses for 1H08 also slowed significantly from 2H07. Net life-insurance income fell by 8.2% y-o-y, due mainly to a loss of HK\$1,030m in investment returns, compared with a profit of HK\$689m for the same period last year.
- **Cost efficiency was stable** Operating expense grew 13.9% y-o-y as the Group's number of full-time equivalent staff rose by 420 compared with 2007 year-end. However, as the operating income trailed expense growth, resulting in a slightly improvement in the cost-to-income ratio to 26.3%, compared to 26.6% for the first and second halves of 2007.
- **Credit quality maintained** Asset quality held up well, with an NPL ratio of 0.41%, unchanged from that at the end of 2007.
- **Mainland operations** China contributed 9.8% of pre-tax profits for HSB in 1H08, up from 5.9% in 1H07 and 7.0% in 2H07. Much of this progress can be attributed to Industrial Bank. The organic pre-tax profit of HSB's China business was just HK\$47m, accounting for a mere 0.4% of the group's total for 1H08. Management indicated that the profit contribution from the mainland would continue to grow as it would set up new branches in Tianjin and Kunming in the second half of 2008. It also plans to increase its total outlets to 50 by 2010, up from about 30 now.
- **Solid profitability** HSB's profitability dropped a little bit, with ROE of 32.8% in 1H08, due to the absence of the dilution gains from its investment in Industrial Bank in 1H07. Meanwhile, the bank's CAR stood at 13.9% as of 30/06/2008.

### Outlook & Prospects

- **Relatively resilient non-interest income** As for other Hong Kong banks, the weak stock-market sentiment hit the securities brokerage fees and sales of equity-linked funds in the first half of 2008. HSB, however, made an effort to introduce various commodity-linked, currency linked products, and China bond funds to retail customers. Also, its life insurance business continued to gain market share and was ranked No. 1 in Hong Kong in terms of new annualised regular life insurance premiums for the 1Q08. As a result, Hang Seng Life recorded robust growth in total net earned premiums of 43.7% y-o-y for 1H08. Overall, with the compensation from non-stock-market-related fees, we believe HSB's net fee income would drop in a lesser extent than other local rivals.
- **Steady Mainland growth expected** Regarding the mainland businesses, HSB lifted headcount by 19.6% (to 1,312), grew loans by 14.7% and increased deposits by 94.1% during 1H08. HSB earned roughly 9.8% of pre-tax profits from China in 1H08. We believe this contribution will grow steadily in coming years, reflecting strong momentum in equity-accounted profits from Industrial Bank (in which HSB owns a 13% stake) and the emergence of profits from HSB's organic expansion (which is still in a relatively early investment phase). However, as the earnings contribution from the organic HSB business is still not too meaningful, due to the large upfront investment, the China's operation will not become a material contributor to group earnings in near term, compared to the Bank of East Asia.



- **Superior risk management** This is evident in its being the only listed local bank that did not invest in collateralized debt obligations (CDOs) and structured investment vehicles (SIVs). Despite the substantial liquidity that HSB has, its lack of CDO and SIV exposure is the evidence to its disciplined management, and we believe HSB could deliver a more resilient performance among the local banks, if credit market pressures re-emerge.
- **Defensive play but upside is limited** The absence of CDO & SIV exposure and high dividend yield of 4.27% make HSB a defensive play but we believe HSB would return to a slow CAGR or even negative growth on its net profit in the coming few years, due mainly to the slowing growth of fee income. We like the franchise, strategy and management quality of HSB, despite it would be challenging for HSB to maintain its high valuations at 17.0x 2008E P/E and 4.98x 2008E P/B. Therefore, we believe that current valuation would only justify a Hold for Yield recommendation.

**Recommendation: Hold for Yield**

**I. Impairment allowances, overdue and rescheduled advances of Hang Seng Bank**

As % of total customer advances	Individual allowance	Portfolio allowance	Non-performing loans	Overdue and rescheduled advances
<b>As of 30/6/2008</b>	0.12%	0.19%	0.41%	0.29%
<b>As of 31/12/2007</b>	0.13%	0.21%	0.41%	0.36%
<b>As of 30/06/2007</b>	0.13%	0.18%	0.46%	0.37%

**II. Comparison of Hang Seng Bank's loan book: 30/06/2008 vs 31/12/2007**

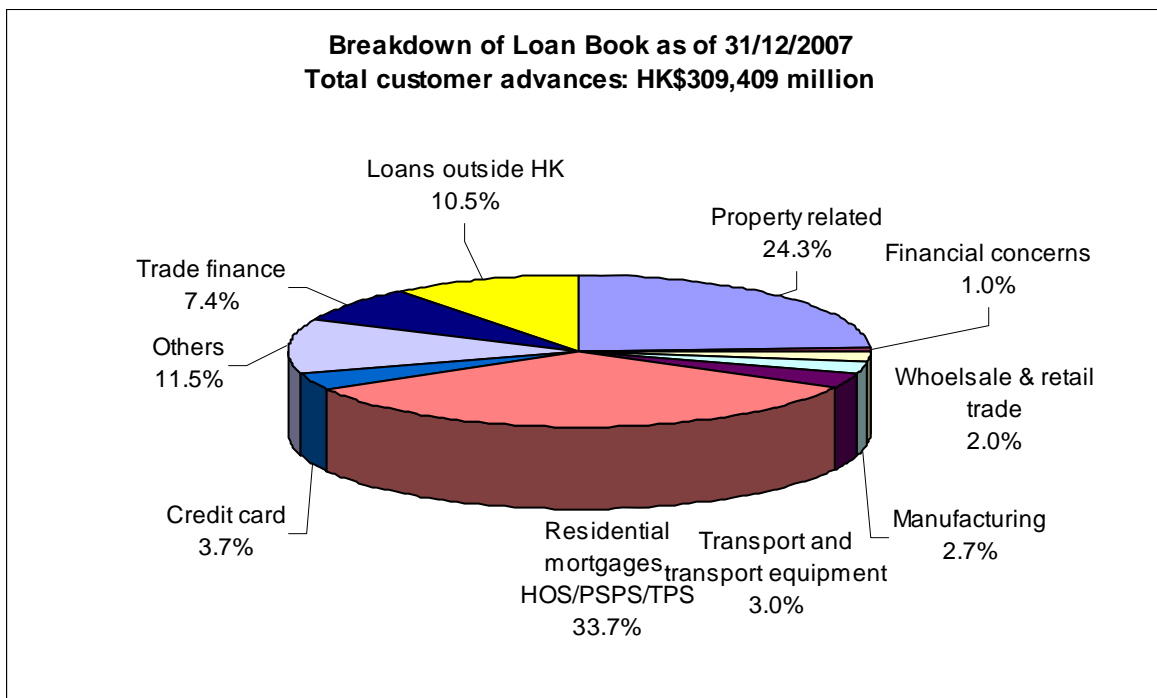
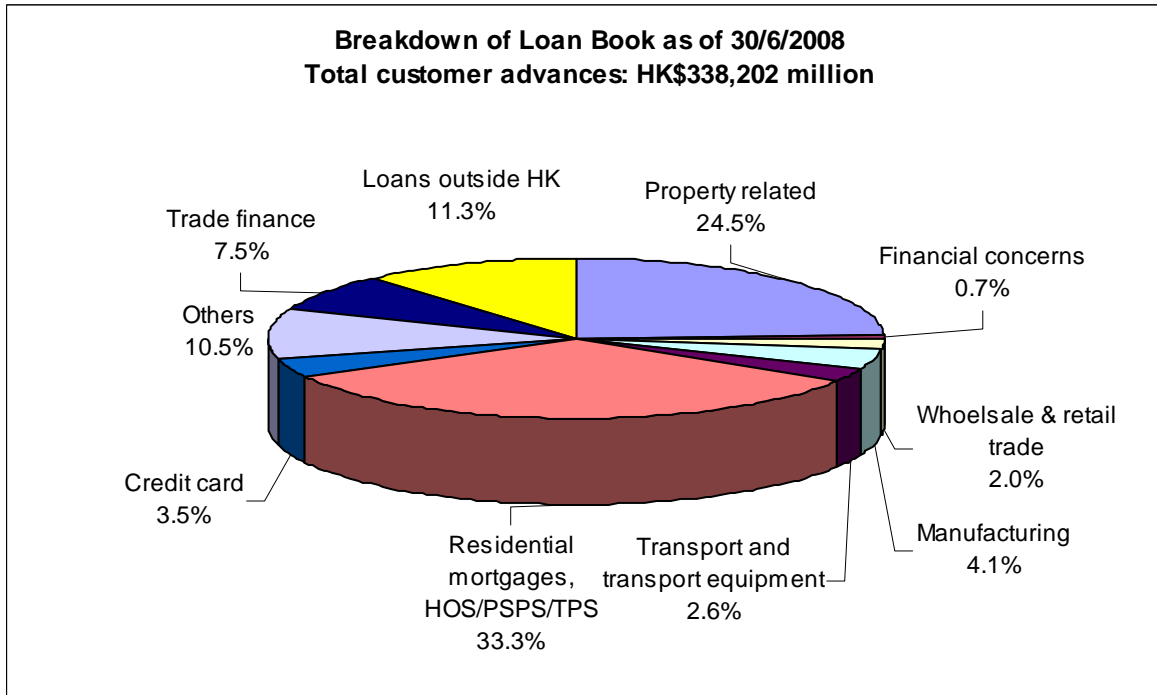
Loans-by industry	30 <sup>th</sup> June, 2008 HK\$ million	Up/(down)	31 <sup>st</sup> Dec, 2007 HK\$ million
Property related	82,909	+10.4%	75,107
Financial concerns	2,468	-23.6%	3,232
Wholesale & retail trade	6,875	+13.9%	6,034
Manufacturing	13,767	+65.6%	8,311
Transport & transport equipment	8,837	-5.7%	9,368
Residential mortgages, HOS/PSPS	112,726	+8.0%	104,360
Credit card	11,685	+2.9%	11,354
Others	35,364	-0.9%	35,682
Trade finance	25,206	+9.6%	22,995
Stockbrokers	313	-40.3%	524
Loans outside HK	38,052	+17.3%	32,442
	<u>338,202</u>	+9.3%	<u>309,409</u>

**III. Comparison of Hang Seng Bank's loan book: 30/06/2008 vs 30/06/2007**

Loans-by industry	30 <sup>th</sup> June, 2008 HK\$ million	Up/(down)	30 <sup>th</sup> June, 2007 HK\$ million
Property related	82,909	+19.6%	69,316
Financial concerns	2,468	+28.7%	1,917
Wholesale & retail trade	6,875	+13.0%	6,084
Manufacturing	13,767	+70.0%	8,098
Transport & transport equipment	8,837	-6.3%	9,431
Residential mortgages, HOS/PSPS	112,726	+10.4%	102,109
Credit card	11,685	+19.2%	9,804
Others	35,364	-29.2%	49,914
Trade finance	25,206	+14.6%	21,988
Stockbrokers	313	-96.1%	7,976
Loans outside HK	38,052	+50.3%	25,315
	<u>338,202</u>	+8.4%	<u>311,952</u>



**Breakdown of loan book of Hang Seng Bank**





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